

No 491 ✓

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CHARLES ELMORE CL.

IN THE
Supreme Court of the United States

OCTOBER TERM, 1940

BASTIAN BROS. CO.,

Petitioner,

vs.

GEORGE T. MCGOWAN, Collector of Internal Revenue
for the 28th Collection District of New York,

Respondent.

**PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SECOND CIRCUIT.**

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Bastian Bros. Co., a corporation of New York, by Remington & Remington, its attorneys, prays that a Writ of Certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Second Circuit entered in the above entitled cause on July 29, 1940 affirming a decision of the District Court of the United States for the Western District of New York, dismissing the complaint of your petitioner.

OPINION BELOW

The opinion of the District Court of the United States for the Western District of New York is published in 32 F. Supp. 93 (R. 61). The opinion of the Circuit Court

of Appeals for the Second Circuit is published in 113 Fed. (2d) 489 (R. 67).

JURISDICTION

The judgment below was entered July 29, 1940. The jurisdiction of this court is invoked under §240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is the certificate of incorporation of Bastian Bros. Co. together with all amendments thereto and the applicable statutes of the State of New York, restricting payment of dividends, "a written contract executed by the corporation" within the meaning of §26(c) (1) of the Revenue Act of 1936?

STATUTES AND REGULATIONS INVOLVED REVENUE ACT OF 1936

(U. S. C. Supp. III, Title 26, Sec. 13a):

"Sec. 14. Surtax on Undistributed Profits.

(a) Definitions.—As used in this title—

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in §27 and the credit provided in §26(c), relating to contracts restricting dividends.

"Sec. 26. Credits of Corporations. In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(c) *Contracts Restricting Payment of Dividends.*—

(1) **Prohibition on Payment of Dividends.**—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.”

Sec. 115. Distribution by Corporations.

(a) **Definition of Dividend.** The term “dividend” when used in this title (except in section 203(a) (3) and section 207(c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Treasury Department Regulations 94, Art. 26-2 provides as follows:

“Credit in connection with contracts restricting payment of dividends:—

(a) The credit provided in §26(c) with respect to contract restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936 which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of §26(c).”

Section 58 of the New York Stock Corporation Law provides:

“§58. **DIVIDENDS.** No stock corporation shall declare or pay any dividend which shall impair its

capital or capital stock nor while its capital or capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number of its shares or of its capital or capital stock, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities including capital or capital stock as the case may be. In case any such dividend shall be paid or any such distribution of assets made, the directors in whose administration the same shall have been declared or made, except those who may have caused their dissent therefrom to be entered upon the minutes of the meetings of directors at the time or who were not present when such action was taken, shall be liable jointly and severally to such corporation and to the creditors thereof to the full amount of any loss sustained by such corporation or by its creditors respectively by reason of such dividend or distribution."

Section 664 of the New York Penal Law provides:

"§664. Misconduct of officers and directors of stock corporations. A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended:

1: To make a dividend, except from surplus, and in the cases and manner allowed by law; * * is guilty of a misdemeanor."

STATEMENT

The pertinent facts are stated in the complaint. Bastian Bros. Co. had a net income for 1936 of \$28,917.87 (R. 3, f. 13) and for 1937 of \$105,321.16 (R. 6, f. 29). During 1930, 1931, 1932 and 1933 Bastian Bros. Co. had each year lost money on its operations, so that during 1936 and 1937

there existed a substantial impairment of capital arising solely from these operating losses (R. 4, f. 16; R. 7, f. 32).

On its 1936 income Bastian Bros. Co. paid as a surtax upon undistributed profits \$4,741.67 (R. 3, f. 14). On its 1937 income it paid as such surtax \$18,590.00 (R. 6, f. 30).

During 1936 and 1937, because of the impairment of capital existing throughout both years, Bastian Bros. Co. could not, without violating the Statutes of New York State, under which the corporation was organized and is existing, declare and pay any dividends. Any director voting for the declaration of a dividend would have violated the Penal Laws of the State of New York.

On October 28, 1938, Bastian Bros. Co. filed a claim for refund of \$4,471.67, the amount which it had paid as the surtax on undistributed profits for 1936 (R. 38-39). On December 27, 1938, Bastian Bros. Co. filed a claim for refund of \$18,590.00, the amount which it had paid as a surtax on undistributed profits for 1937 (R. 53-54).

The claims for refund were neither allowed nor rejected and suit for refund was commenced by the filing of a complaint and issuance of a summons on September 19, 1939. A motion to dismiss the complaint for failure to state a cause of action was granted and judgment entered March 15, 1940. Appeal to the United States Circuit Court of Appeals for the Second Circuit was taken and on July 29, 1940 the judgment of the District Court was affirmed.

The District Court held that this case was controlled by *Crane-Johnson Co. v. Commissioner*, 105 Fed. (2d) 740 (CCA-8th) which was decided against the taxpayer (R. 63). The Second Circuit affirmed upon the opinion of the District Court and stated per curiam that both the text and legislative history of §26(c) (1) supported such decision.

The Second Circuit declined to follow the decision of the Ninth Circuit in favor of the taxpayer. (*Northwest Steel Rolling Mills, Inc. v. Commissioner*, 110 Fed. (2d) 286.)

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

1: In holding that a charter of a corporation is not a "written contract executed by the corporation" within the meaning of §26(c) (1) of Revenue Act of 1936.

2: In holding that the credit permitted under §26(c) (1) of the Revenue Act of 1936 does not apply to corporations prohibited by state law from declaring or paying dividends out of net profits while the capital of the corporation is impaired.

3: In affirming the decision of the District Court.

4: In holding that the legislative history of §26(c) (1) shows that Congress intended to deny relief to corporations which could not declare dividends because of impairment of capital.

REASONS FOR GRANTING THE WRIT

1: The Circuit Court of Appeals Second Circuit has rendered a decision in conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit (although in harmony with that of the Eighth Circuit). The three cases are essentially similar, all involving the construction of §26(c) (1) of the Revenue Act of 1936 where a state statute prohibits the payment of dividends by a corporation because of the existence of a capital deficit. In both the Ninth and Second Circuit cases, the state prohibition

is on the corporation as well as the directors. The third case, *Crane-Johnson Co. v. Commissioner* (105 Fed. (2d) 740) (C. C. A. 8th) is in accord with the present case and in conflict with *Northwest Steel Rolling Mills, Inc. v. Commissioner* (110 Fed. (2d) 286). The Court of Appeals for the Second Circuit recognized the conflict, but after citing the two cases, merely said, "We agree with the former decision" (R. 69).

2: The question presented by the present case is an important question of federal income tax law and one of general interest, not heretofore heard by this Court and which should be determined by this Court. The question affects all corporations in the United States which had an impairment of capital stock in 1936 or in 1937 and which made any profit in either of those years. A Writ of Certiorari to the Court of Appeals for the Eighth Circuit has been granted by this Court in the *Crane-Johnson* case, (309 U. S. 692). The Commissioner has petitioned for a Writ to the Circuit Court of Appeals for the Ninth Circuit in the *Northwest Steel Rolling Mills, Inc.* case. Granting of this petition will aid in the determination of all the material issues involved in the three cases.

3: It is submitted the Court below has decided the question presented in an untenable way, because: (1) it is elementary law that the charter of the corporation is a written contract embracing among its terms the provisions of the State Statute; (2) Statutes of New York expressly prohibit the petitioner declaring dividends; (3) by this provision in writing, expressly dealing with the payment of dividends, part of its charter, petitioner was restrained from paying dividends.

4: It is submitted that an important item of the legislative history of §26(c) (1) has not been given its true significance.

When the Crane-Johnson case was before the Board of Tax Appeals, the Board assumed that §14 of the House Bill, subsequently eliminated, was intended to give relief to corporations which could not legally pay dividends. The Board, and presumably the Second Circuit, reasoned that the elimination of §14 in the final act showed an intent to exclude deficit corporations from the credit section (26).

A careful analysis, however, indicates that §14 of the House Bill was intended to afford relief to those corporations which *could legally* pay dividends, but which, nevertheless, would have gotten no credit, because of the definition of "dividend" in the law as it then existed. The inequity which §14 of the House Bill was intended to remedy was later cured by an amendment to §115(a), defining dividends. Therefore the elimination of §14 of the House Bill should not be taken to mean (as the Commissioner contends) that Congress intended thereby to deny the benefits of §26(c) (1) to those corporations which *could not legally* pay dividends.

The whole history of the Undistributed Profits Tax sections show that the purpose and intent of the law was to tax corporations which had profits and *would not* distribute them, and to relieve corporations which, though they had current profits, because of debts and deficits *could not* distribute them.

Respectfully submitted,

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